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DIOCESAN ATTORNEYS' PAPERS

APPLICATION OF UNRELATED BUSINESS INCOME TAX TO CHURCHES

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The Tax Reform Act of 1969 extended the application of the unrelated business income tax to churches, and conventions and associations of churches, but deferred its application in the case of any trade or business carried on by such an organization before May 27, 1969. In the case of any such preexisting trade or business, the tax will become applicable for taxable years beginning on and after January 1, 1976. This transition rule was not made applicable to unrelated debt-financed income—that is, income from property acquired in whole or in part with borrowed funds. Thus, the unrelated business income tax has already been applicable since January 1, 1970, to churches with respect to income from any unrelated trade or business which was undertaken on or after May 27, 1969 and with respect to income from debt-financed property.

These effective date provisions set the stage for the mammoth problems of compliance facing churches beginning in 1976 and indicate that it may have been necessary to consider these problems in depth even before now. Much effective planning can be done to minimize these problems—both during the balance of 1975, and in 1976, and later years when the tax is fully applicable. The purpose of this paper is to point up some of the planning opportunities.

Particularly relevant to these provisions is a special restriction on examination of the books of a church included as part of the 1969 Act changes. No examination of the books of a church or convention or association of churches may be made to determine whether such organization is engaged in an unrelated trade or business unless an Internal Revenue Service official of the rank of Regional Commissioner or higher notifies the

organization in advance of the examination that he believes the organization may be so engaged. If there is no reasonable basis for such a finding, it is possible that this determination may be challenged by federal district court action to enjoin an IRS audit of the church's books, with the federal court then determining whether there is any reasonable basis for such a belief.

Further, no examination of the religious activities of such an organization may be made except to the extent necessary to determine whether it is a church, or association or convention of churches, and no examination of the books of the organization may be made except to the extent necessary to determine tax liability.

The Treasury Regulations elaborate upon these audit restrictions on the Internal Revenue Service in several ways. They indicate that an IRS audit may be undertaken for any of four purposes: (1) to determine tax exemption qualification under section 501(c)(3); (2) to determine whether the organization qualifies as one to which contributions are deductible as charitable contributions; (3) to verify payments to another person in determining the tax liability of the recipient, such as salaries or wages; and (4) to determine any tax liability of the organization, including but not limited to the unrelated business income tax. The Regional Commissioner's notification must be given in all these cases, at least 30 days prior to the examination. The Regional Commissioner may conclude such examination is necessary only after reasonable attempts have been made to obtain information from the church's books by written request and it has been determined that the information cannot be fully or satisfactorily obtained in that manner. The Regional Commissioner's notification is not necessary, however, as a prerequisite to examination of the religious activities of the organization to determine whether it is in fact a church.

Both the effective date provisions and the audit restrictions depend on whether the organization is a church or convention or association of churches. This concept includes a religious order or religious organization only if it is an integral part of a church and is engaged in carrying out the functions of a church. It will be deemed an integral part of a church only if it is closely connected with and to some substantial extent controlled by the church. It will be engaged in carrying out church functions if its duties include the ministration of sacerdotal functions and the conduct of religious worship, determined in light of the tenets and practices of the particular religious body constituting the church.

The application of the unrelated business income tax to churches may be divided into three distinct areas—first, its general application to income-producing activities which are not related to religious functions; second, its application to advertising revenues from publications; and third, its application to income from debt-financed property. Each of these areas presents special planning problems for church activities.

Unrelated Income-Producing Activities

The tax basically applies to income of any exempt organization from the active conduct of any trade or business "regularly carried on" by it which is "not substantially related to its exempt functions." In general, with various exceptions, it does not apply to passive income such as dividends, interest, or rent from real property unless such passive income arises from debt-financed property. It does, however, apply to interest, annuities, rents, and royalties from an organization controlled by an exempt organization, whether such controlled organization is taxable or tax-exempt, to the extent that such a controlled organization realizes income which would be unrelated business income if realized directly by the controlling exempt organization.

There is a *de minimis* exemption, or specific deduction, of \$1000 which, in the case of a Diocese, province of a religious order, or convention or association of churches, is allowed with respect to each parish, individual church, district, or other local unit. The \$1000 exemption for any such individual unit is limited to the unrelated business income of that unit so that any excess cannot offset unrelated business income of another individual unit.

The first standard is whether the business activity is regularly carried on. This depends on whether it regularly recurs; thus, the operation by a church of its parking lot regularly on Saturdays as a commercial lot for shoppers will be taxed. On the other hand, activities engaged in only discontinuously or periodically, and conducted without the competitive and promotional efforts typical of commercial activities, such as publication of advertising in church bulletins, high school annuals, or programs for sports events would not be taxable. Similarly, certain infrequent but recurring activities—such as occasional bazaars, dances, carnivals, or similar fund raising activities—are not taxable.

The narrowness of these exceptions in the Treasury Regulations suggests, however, the extreme breadth of application of the tax. This indicates the need for comprehensive review of every source of gross income other than contributions by church members.

The second, and more critical, standard is whether the activity is "substantially related to" the exempt functions of the church. This must be resolved with reference to the underlying principle of these provisions: that if exempt organizations engage in competition with taxable enterprises, they must carry the same tax burden. A university is subject to tax on the income from sales of ice cream or cheese at its creamery, even though it provides an extensive agricultural curricula, because the processing is a "business" activity. A church operating a bookstore carrying a broad range of titles and conducted from a location which places it in competition with commercial bookstores in the community will undoubtedly be taxable.

Some specific church activities are not taxable. The following activities are probably excluded in all events if they are carried on in connection with church operations: the operation and maintenance of cemeteries; the ownership and operation of nursing, retirement, and other similar houses and institutions; the sale of religious articles; and the printing and sale of religious pamphlets, calendars, papers, books, and magazines with a substantial religious content (even though a small amount of advertising is included). Also, the sending out of low cost articles incidental to the solicitation of charitable contributions is not to be treated as a sale of such articles where the contributions, less reasonable administrative costs, accrue fully to the charitable organization.

There are specific exceptions for activities where substantially all of the work is performed by volunteer workers without pay, as where a church or any of its subsidiary organizations or groups operates a consignment shop selling clothing, antiques, or other goods almost entirely with volunteer help. Similarly excepted is an activity conducted primarily for the convenience of members, students, patients, or employees, such as a cafeteria for visitors at the National Shrine. There is also an exception for the sale of goods substantially all of which are received as gifts or contributions, such as the conduct of a white elephant shop by a church.

Assuming the application of the tax, a second set of different but equally difficult problems arise—the allocation of costs of facilities and personnel of the exempt organization to the taxable activity. Generally, such an activity is not operated by the exempt organization as a wholly separate, self-contained function, and some part of the general administration costs of the exempt organization should properly be taken into account in determining net income from the activity. This poses particular difficulty for church activities where many personnel involved may not be compensated at all because of a vow of poverty, or may be paid salaries for less than the value of their services.

The Treasury Regulations provide that costs must have a “proximate and primary relationship” to the carrying on of the business activity to be deductible. Expenses, depreciation, and similar deductions attributable solely to the conduct of the business activity are obviously allowed. Where buildings, other facilities, or personnel are used both to carry on exempt functions and to conduct the business activity, depreciation, salaries, and other deductible items, including general overhead costs, may be allocated on any reasonable basis. Thus, if a local parish church should operate its parking lot on Saturdays as a commercial lot, and if the parish priest could be said to spend 10 percent of his time overseeing such operation, 10 percent of his salary would be allocable in determining the unrelated business income from such operation.

As a practical matter, it will be extremely difficult to allocate costs

adequately if unrelated business activities are conducted directly by the church organization. Thus, it becomes important to consider a transfer of activities that seem clearly to be taxable as unrelated business activities to a separate organization where a full set of costs may be properly incurred and charged against the income in determining the net amount subject to tax. Where such business activity otherwise results in profits, such an organization may and probably should pay salaries or wages to all persons engaged in conducting the activity to the extent of the full value of their services, even though they continue to be engaged also in performing church functions, and even though because of a vow of poverty or otherwise, they immediately contribute back all or part of such wages to the church controlling such separate organization. Such salaries or wages should still be fully deductible by the separate organization conducting the business activity, and while the individuals involved will be taxable on the wages or salaries received, they will be entitled to deduct up to 50 percent of such amounts of contributions thereof back to the church. Further, in most instances, the additional tax incurred by such individuals will be substantially less than the corporate tax that would otherwise be paid on such profits.

Special attention should be given to unrelated business activities which result in losses. An exempt organization is taxable only on the net profits from all of its unrelated business activities combined; that is, losses on some unrelated business activities may offset profits on others. If profit-making, unrelated business activities are to be transferred to a separate corporation, loss-making, unrelated business activities should either also be transferred to such separate organization or to other separate organizations which are structured so that consolidated returns may be filed in which losses of one controlled organization offset profits of others.

There are two sets of rules to be considered in connection with the "spinoff" of such unrelated business activities to a separate organization. First, where real estate is involved, it could conceivably be more advantageous to lease the property to an *unrelated* organization. Thus, as previously stated, passive income is excluded from unrelated business income tax, and this generally includes rents from real property. Income from active operation of real property will, however, be taxable where the real property is operated as part of an unrelated business—such as the operation of a factory or retail store. This would also include the case when the income arises primarily from the provision of services to the occupant rather than the rental of the real estate, such as the operation of a hotel, motel, boarding house, tourist camp, parking lot, warehouse, or storage garage. Such operations will result in unrelated business tax. On the other hand, the ownership and operation of the typical office building, apartment building, or shopping center, or a lease of factory buildings to someone else, produces only rental income excluded from the unrelated business

income tax. The provision of incidental services to tenants in general, such as the furnishing of heat and light, the cleaning of public entrances, hallways, and common space, the collection of trash, and similar activities are not deemed to be the providing of services to specific occupants and thus do not result in losing the exemption from the tax.

Where the income from real property would otherwise be subject to the tax, it may be best simply to lease the property to an unrelated user, who will conduct the business formerly conducted by the exempt organization. The exempt organization will receive rent for the use of the property, exempt from tax, if the following conditions are met. The rents must not depend in whole or in part on the income or profits derived by any person from the property leased, although they may be based in whole or in part on a fixed percentage of gross receipts or sales, as in a common form of commercial store lease. The rent is not excluded from tax to the extent it is attributable, other than to an incidental degree, to personal property as opposed to real property. The regulations provide that, generally, rents attributable to personal property will be deemed more than an incidental amount if they are more than 10 percent of the total rents. Thus, if more than 10 percent of the rent is attributable to personal property, this portion of the rent will be taxable, although the remaining portion attributable to the real estate will not be taxable. If, however, more than 50 percent of the rent is attributable to personal property, the entire rent becomes taxable.

The allocation of the rent between the real estate and the personal property will not be governed by the terms of the lease or by the execution of separate leases. It will depend on the relative fair leasing value of the real estate and the personal property at the time the property is first placed in service by the lessee.

If a church were to own a factory, in order to convert income from operation of the factory, taxable as unrelated business income, to rent, excluded from the tax by leasing the factory to an uncontrolled third party, it would be necessary to determine the fair rental value of the real estate on the one hand and of the equipment and other personal property on the other hand. The personal property could be sold outright to the unrelated user, without incurring unrelated business income tax, as hereinafter indicated, and the real estate could be leased, possibly along with some part of the personal property to the extent it was assured that the rent attributable to such leased personal property was less than 10 percent of the total rent.

Of course, alternatively, the real estate could be sold to the unrelated user, either outright or for a long-term mortgage note producing interest income, which interest would also be exempt from the unrelated business income tax.

Sales of property require special care. Sales before January 1, 1976, will not ordinarily result in tax to a church in any case unless the property

is debt-financed property. Otherwise, the unrelated business income tax provisions exempt from the tax all sales of property except inventory-type property or property held primarily for sale to customers in the ordinary course of business. Buildings, equipment used in manufacturing or sales activity, and similar assets ordinarily are not inventory-type property or property held for sale to customers because they are assets *used* in the trade or business of manufacturing, selling, or rendering services, and are not products held for sale.

To recapitulate, property may ordinarily be sold by a church before January 1, 1976, without tax unless it is debt-financed property. After that time, any gain on sale will result in tax if the property is inventory-type property or property held for sale to customers, or if the property is debt-financed property.

The second type of "spinoff" of unrelated business activities to be considered is a transfer to a "controlled" organization. While interest, annuities, rents, and royalties are generally passive income, excluded from unrelated business tax, they are not excluded if received from a controlled organization if such controlled organization has income which, if received directly by the controlling organization, would be unrelated business income. The reason for this rule is relatively obvious; these amounts are deductible in determining taxable income, and without such a rule, an exempt organization could transfer its unrelated business activities to a controlled organization, whether taxable or tax-exempt, and siphon off the profits in amounts which are both deductible by the controlled organization as interest, annuities, rents, or royalties and are otherwise excluded from unrelated business income tax in the hands of the controlling organization as one of such forms of passive income.

Thus, while there is a distinct advantage in transferring unrelated business activities to a controlled organization to achieve accounting segregation and to permit a full share of costs to be charged against such income, that is the only advantage. The basic application of the tax to the true net income from such activities cannot be defeated by attempting to withdraw the profits as deductible interest, annuities, rents, or royalties. The controlling organization, that is, the church or any of its affiliated organizations, may receive these once-taxed profits as dividends on the stock representing the controlling interest, which dividends themselves will not be subject to tax.

Further, such a controlled organization may contribute and deduct up to five percent of its taxable income (determined before considering such contribution as a charitable contribution.) Such a contribution could be made to the church which is its controlling shareholder. Thus, to this extent, the unrelated business income may completely escape tax.

"Control" for these purposes is defined in the case of stock corporations as ownership of 80 percent of the voting power and 80 percent of all nonvoting shares, and in the case of nonstock corporations, as 80 percent of the directors or trustees being representatives of or being directly or indirectly controlled by an exempt organization. A director or trustee is deemed to be controlled by an exempt organization if he may be removed by such organization. Thus, an exempt organization could avoid these rules, and siphon off profits of another organization operating the unrelated trade or business as interest, annuities, rents, or royalties, completely escaping tax on the income to this extent, if an unrelated third party owns more than 20 percent of the stock, or has more than 20 percent of the control of a nonstock corporation.

Where it is feasible to transfer an unrelated business activity to a separate organization, then a number of considerations come into play. Assume first that more than 20 percent outside ownership is not feasible, so that it will be a controlled organization. Ordinarily there would be no advantage in organizing it as a controlled exempt organization as opposed to a controlled taxable organization; the income from the unrelated business activity would be fully taxable in any event.

If the assets involved, or some of them, have a current value exceeding their original cost less depreciation allowed or allowable, there may be an advantage in selling them to the new organization rather than transferring them in exchange for stock. Inventory-type assets and assets held for sale to customers must be sold before January 1, 1976, to avoid tax. The sale of assets to the controlled organization without recurring tax where their current value exceeds their original cost less depreciation allowed or allowable may be advantageous to give these assets a new, higher basis.

The sale of assets to a controlled organization is, however, a difficult transaction to sustain. If cash is transferred for stock and immediately withdrawn as the purchase price of the assets, the transaction will be disregarded and treated as a transfer of the assets for stock with no step-up in basis. If the assets are sold for a purchase-money obligation of the new controlled organization, it must be adequately capitalized under the "thin incorporation" doctrine. The sale of assets for long-term, purchase-money notes which are deemed to be "securities" in connection with a transfer of other assets for stock will not result in the step-up in basis.

Nonetheless, it may be possible in a carefully organized transaction to transfer sufficient assets for stock, so the corporation is deemed adequately capitalized, and sell other assets for short-term notes to obtain a stepped-up basis. There is little to be lost and much to be gained by attempting such a transaction.

While it would be necessary to provide for interest on such a sale at a rate of at least four percent, and while such interest would be taxable to

the exempt organization under the controlled corporation rules, the interest would be deductible by the controlled organization so there would be no net disadvantage from this treatment.

Where more than 20 percent outside ownership is feasible, it is possible as already stated to shelter income completely from tax by leasing real property to the controlled organization or by realizing part of its profits as interest, annuities, or royalties.

In either event, as previously indicated, the controlled organization should pay salaries or wages to all persons providing services in connection with the unrelated business activities. Such salaries or wages may be as high as the fair value of their services, minimizing tax on the unrelated business activities and shifting the burden of tax to lower bracket individuals.

Advertising Revenues From Publications

The second major area of application of the unrelated business income tax to churches and affiliated organizations after 1975 will be with respect to advertising revenues in church publications. Brief reference has already been made to the fact that such revenues will not be taxable where they are intermittent and occur without the competitive and promotional efforts typical of commercial endeavors, such as in church bulletins or high school annuals, or where they are small in amount and occur in church publications with substantial religious content. It is not at all certain where this leaves a publication such as the weekly Catholic Standard newspaper in this diocese, which carries substantial advertising; it seems likely that it will be subject to tax on its net income from advertising.

The taxable income from advertising is the excess of the advertising revenues over direct advertising costs and over the excess, if any, of editorial and readership costs over subscription income. Thus, if the editorial and readership costs of the publication exceed subscription income, this excess may also be deducted from advertising income to determine taxable income, though not to create a loss (which might otherwise be used against other unrelated business income of the exempt organization). The key issue dealt with by the proposed new advertising regulations—that is, determination of real subscription income of exempt organizations which are membership organizations where the members pay both dues and subscription price—probably does not arise with respect to most publications of a church, where dues are not paid by members.

A second critical issue in the determination of taxable income from advertising is the extent to which various publications of the exempt organization may be consolidated, some containing little or no advertising, so as to increase total publication costs to be offset against advertising revenues. Thus, could pamphlets or other publications of the Archdiocese

of Washington be combined with the Catholic Standard so as to offset the total cost of all such publications in excess of income from sales of such publications against advertising revenues of the Catholic Standard? The proposed regulations provide that to be consolidated, it must be contemplated with respect to any particular publication that total revenues from advertising and circulation will exceed publication costs, so as to result in net profit, though not in any particular year. A periodical will generally be treated as meeting this standard if advertising revenues are generally at least 25 percent of total costs. Provision is made for recognizing that start-up losses will occur in a publication undertaken for eventual profit.

The third major issue in determining taxable income from advertising is again the allocation of costs of the exempt organization. The same problems exist here in the allocation of indirect costs of the organization, particularly, general and administrative expenses, as have already been discussed. For the same reasons, it may be advisable to segregate publication of any periodical containing substantial advertising not "related" to the exempt functions of the organization, and thus subject to tax, in a separate taxable corporation. Such a corporation should pay a full share of general and administrative expenses, including salaries and wages of all persons rendering services equal to the full value of such services.

Unrelated Debt-Financed Income

The final major area of application of the unrelated business income tax to churches is with respect to debt-financed property. As previously stated, these provisions have already been applicable to churches since the beginning of 1970. They are singularly a trap for the unwary because of their surprisingly broad reach and their extreme complexity.

The true effect of these debt-financed property provisions is to make income taxable even though it is passive in nature and otherwise excepted from operation of the unrelated business income tax. Thus, dividends, interest, rents, royalties, annuities, and gain from the sale or exchange of property are taxable to the extent the property producing such income was acquired as a result of borrowing funds, directly or indirectly. Further, for the period 1970 through 1975, until the unrelated business income tax becomes generally applicable to churches, these provisions are broad enough to tax income derived from or on account of debt-financed property in any form it arises, as from operation of such property, even though not in the form of dividends, interest, rents, royalties, annuities, or gain from the sale or exchange of such property.

In general, the income is taxable in the same ratio that the average acquisition indebtedness bears to the average adjusted basis of the property. Average adjusted basis must be determined for this purpose by reducing original cost by depreciation for all prior years while the property was

held by the exempt organization even though it was not subject to tax on the income from such property.

An acquisition indebtedness is deemed to exist whether the exempt organization assumes a debt on acquisition of the property or merely acquires the property subject to a mortgage, whether or not the property acquired is secured by the debt, and whether or not the debt comes into existence at the same time as the property is acquired. An indebtedness incurred prior to the acquisition of property will be related to such acquisition for this purpose if it would not have been incurred but for such acquisition or improvement. An indebtedness incurred after acquisition of property will be related to such acquisition for this purpose if it would not have been incurred but for such acquisition or improvement and if the incurring of the debt was reasonably foreseeable at the time of such acquisition of indebtedness.

The broad reach of these provisions is best illustrated by an example in the regulations dealing with a case in which an exempt organization sells property in a transaction in which it takes back a purchase-money mortgage for part of the selling price. The exempt organization then acquires or constructs replacement property financed in part by a mortgage. Even though the replacement property is used entirely by the organization in its exempt functions, as would be a church building, and produces no income, the purchase-money mortgage taken back on sale of the original property, as an asset of the organization, is deemed to be debt-financed property. The interest received on the purchase-money mortgage asset of the exempt organization is taxable in the same ratio that the amount of the mortgage executed to acquire or construct the replacement property bears to the adjusted basis of the purchase-money mortgage in the hands of the exempt organization. This result is reached because it was reasonably foreseeable at the time the purchase-money mortgage was taken back that the acquisition or construction of the replacement property would be required to be financed if all cash were not received on sale of the old property. Thus, the mortgage executed to acquire or construct the new property is deemed to have financed the acquisition of the purchase-money mortgage as an asset of the exempt organization.

It is incumbent on any exempt organization to consider whether any indebtedness incurred by it, or any lien on property which it owns, however remote from the acquisition, will be treated as acquisition indebtedness for this purpose. A mortgage on real property which an exempt organization acquires in a corporate liquidation will be so treated even though the exempt organization assumes no liability and is not even aware of it. A pledge of investment securities for a loan to replace working capital of the exempt organization depleted by its investment in other property may give rise to an acquisition indebtedness.

Fortunately, there are some exceptions to these broad rules. Debt-financed property does not result in taxable income if substantially all of the use of such property is substantially related to the exercise by the exempt organization of its exempt functions. If a church or any of its affiliated organizations acquires real estate for the purpose of using such property within 15 years for purposes substantially related to the exercise by the church of its religious, educational, or other charitable purposes, the property, even though debt-financed, is not subject to tax so long as the organization does not abandon its original intent to use the property for these purposes within the 15-year period. The church must, however, by the fifth year after acquisition establish that such intended related use is reasonably certain. This exemption applies with respect to structures on the land, however, only if such structure must be demolished to achieve the intended use related to the organization's exempt function. The exemption will not in any case apply to structures erected after acquisition and before the property is put to such intended related use.

There is also an exception for property acquired by bequest or devise subject to a mortgage. In such event, the mortgage debt is not treated as acquisition indebtedness for 10 years. If the property is acquired by gift, a mortgage debt to which the property is subject will not be treated as acquisition indebtedness for 10 years if the mortgage was placed on the property more than five years before the gift and the property had been held by the donor more than five years before the gift. Neither of these exceptions will apply, however, if the exempt organization assumes that liability or pays anything for the equity in the property.

There are also special rules for debts in the form of annuities given in exchange for property, federal financing assistance for low-income housing, and some other special cases.

Obviously, planning in this area is very specialized in view of the extreme precision of the statutory provisions. The key is alertness to the danger of incurring indebtedness outside the church organization in any form, or even acquiring property subject to a mortgage except with realization of the tax burdens it may create currently or in the future.

Conclusion

The application of the unrelated business income tax provisions to churches requires immediate and continuing attention by this group. There are many opportunities for constructive planning to minimize the impact of the tax. With a properly organized structure, the burden may not be so great as many fear and churches can live with this new encroachment on their traditional activities, rendering unto Caesar the things that are Caesar's and unto God the things that are God's.

DISCUSSION

BERNARD HUGER, ST. LOUIS:

If a tax-exempt organization engages in an unrelated business, where is the point where the organization will lose its section 501(c)(3) exemption? How do you measure that, if you can?

NOLAN:

There is no clear-cut or formula-type of measurement. You must make a judgment whether the principal purposes of the organization have changed from engaging in religious, educational, or charitable activities to the conduct of profit-making enterprise. Only if, in an overall sense, its essential purpose has changed to profit-making activities, would it lose its exemption. I'm inclined to think that the application of the unrelated business income tax to churches and affiliated organizations will decrease the risk of loss of exempt status generally because the Internal Revenue Service will be entitled to collect taxes on income-producing activities. That should decrease their inclination to attack the basic exemption from tax. However, if an organization were to change the main stream of its activities and engage principally in, and devote most of its energies and activities to, the conduct of unrelated business activities, it could lose its exemption.

HUGER:

I'm thinking that, if like you spin something off into a separate not-for-profit corporation and have this not-for-profit corporation conduct, let's say, unrelated functions and related functions, it might be 50-50, then that spunoff corporation might lose its exemption.

NOLAN:

That's possible. Although, as I've indicated, I really have not been able to see in general where there is any advantage in spinning off unrelated business activities to an organization which you attempt to make an exempt organization. It seems to me you don't accomplish very much

HUGER:

Well, you accomplish this—let's suppose you've got an outflow corporation that has a data function, and they spin this data function off to a not-for-profit separate corporation, and this separate corporation is doing 50-50 outside business and inside business. Any profits on the inside business, I'd say, would then be tax free. So that would be an advantage.

NOLAN:

It is specifically recognized in this statute that these controlled organizations may be either taxable or tax-exempt. This statute is structured to deal with that problem. Furthermore, there is clearly in the legislative history of the 1969 Act an encouragement to churches to spinoff their unrelated business activities to separate organizations, whether taxable or tax-exempt. In light of that, I'm inclined to think that if they do so in a case like you indicate, insofar as the controlled organizations were conducting exempt activities or related activities, it would not lose its exemption.

FRANCIS O'CONNOR, DUBUQUE DIOCESE:

I have two questions, and they both relate to the religious who have taken the vow of poverty.

You indicated that where you might separate the unrelated business function into a separate organization, that salaries perhaps should be fully paid, that the recipient would pay tax and contribute back to the organization and get a deduction. Are you assuming in that instance that the salary would be taxable for the recipient, even though he's under the vow of poverty, or are you thinking of the typical Diocesan priest who is perhaps subject to income tax?

NOLAN:

It is my understanding that the amount would be fully taxable to the person even though he were subject to a vow of poverty. He would be entitled to a deduction for 50 percent under the charitable contribution rules. It seems to be that unless you assume such treatment, it is possible that the deduction would be lost at the controlled organization level.

O'CONNOR:

Well, I'm assuming that we still have the benefit of the tax-free income to the person who has taken the vow of poverty so long as he's doing it pursuant to the Superior and he's accountable to the Superior for the income, etc.

NOLAN:

Well, that's a difficult problem. If there is a binding obligation in all events to return the amounts, they may well not be deductible by the controlled organization. On the other hand, if you assume that this vow of poverty is not a binding *legal* obligation, the amount would be deductible by the controlled organization and would be taxable. There will always be

a practical problem with the IRS, however, if you pay amounts for which you claim a deduction for the controlled organization, but which are not taxable to the recipient. If you pay salaries or wages which are deductible by the controlled organization, ordinarily those amounts should be taxable to the recipient, although the recipient would be entitled to the charitable contribution deduction. I'm not certain that I really know the final answer to that, but I certainly see a problem in that instance if the recipient does not report the amounts.

O'CONNOR:

The next question is really related to the first one, if you've already answered it, and it's this: If the religious does not take any salary and just has it in the form of contributed services, is IRS going to allow a deduction for the value of those services, even though the salary may not be paid, in arriving at net income?

NOLAN:

No.

O'DONNELL, DIOCESE OF HONOLULU:

On substantially controlled property by the Church, take for instance, the Holy Name Society is controlled by the Church. However, the Holy Name Society operates pretty much independently and controls their own finances. Now, the investments that the Holy Name Society makes and the interest and dividends that they accumulate are not controlled by the front office. Does that come under the taxable item?

NOLAN:

Well, so far the Holy Name Society has been treated as part of the Church for all purposes of the Internal Revenue Code. They have been exempt from tax for that reason. It seems to me that the Holy Name Society will face the same problems as the Catholic Church in general. That is, if they are realizing dividends from property, they must be assured the stock is not debt-financed property if they are to avoid tax liability. If they are realizing interest, rents, royalties, or annuities from an organization which is controlled by the Holy Name Society, or by the Church, those amounts may be taxable under the controlled organization rules.

O'DONNELL:

Another question I had was: In 1968, we purchased property for the expansion of a high school. Now, that expansion is not going to be realized,

and it's possible that we may spinoff that property on a sale. Will that property, now, after 1976, be subject to the capital gain?

NOLAN:

I would say no. It is not inventory-type property or property held for sale to customers. It was acquired originally for exempt purposes. Accordingly, gains from the sale of that property should not be subject to the unrelated business income tax to any extent, assuming it was not debt-financed property.

O'BRIEN, BURLINGTON:

Could you kindly define what is meant, in further specificity, if you would, please, by the words "replacement property" in reference to debt-financed property?

NOLAN:

The replacement property problem arises under the debt-financed property provisions at any time that you sell one asset, receive back a purchase-money obligation, which is an asset in your hands, and which produces interest income which would otherwise be exempt from the unrelated business tax, and you then acquire or construct other property to replace the property sold, which replacement property is financed with indebtedness. Such indebtedness incurred to acquire or construct the replacement property may be reasonably foreseeable at the time you sold the old property and took back the purchase-money obligation. In such case, the purchase-money obligation received on sale of the old property is a debt-financed property acquisition. It need not be replacement property; any acquisition of debt-financed property could create the problem if the incurring of such indebtedness to acquire the property was reasonably foreseeable at the time the purchase-money obligation was acquired.

QUESTION:

Do you distinguish between intra-Diocesan financing and extra-Diocesan debt financing?

NOLAN:

Yes. It is necessary to look at the Diocese as a whole, and I don't think that borrowing money within the Diocese, in effect borrowing from yourself, creates the kind of indebtedness that you need to be concerned about. It's only when you incur indebtedness to outside parties.

QUESTION:

What about another Diocese?

That's a real question. I'm from Juneau, Alaska, and we have a loan from another Church entity on some of our property, and I'm wondering how that might be treated.

Let me tell you how that might develop. Where, for instance, a large Diocese is broken up into two or more smaller Dioceses for the purpose of facilitating administration, we might have the larger parent Diocese helping the smaller Diocese off its feet, or onto its feet.

NOLAN:

I don't know the answer to it, although I am concerned about it, because there are separate organizations involved. If they are separate corporations in the eyes of the law, it may well create acquisition indebtedness. I don't really think I can answer that with any certainty. It really depends upon how you view the Catholic Church, as one great overall entity or as a series of separate organizations. Perhaps others here who have had more immediate dealings with the Internal Revenue Service in connection with the affairs of a particular Diocese could give more information on how the IRS would regard one Diocese as to another. I don't think I can answer that with certainty. I am, however, concerned about the danger there.

QUESTION:

Could you explain some more about the \$1000 deduction and particularly how it will affect each unit? For example, what cannot be done with the aggregate total of the deductions and what can be done with them?

NOLAN:

It means that each parish church may earn unrelated business income—net unrelated business income—up to \$1000, without being concerned. The \$1000 exemption operates much like a dependency exemption on your individual return. Each separate parish church is entitled to a specific deduction of \$1000. However, that \$1000 deduction is limited in the case of each parish church or other individual unit to the unrelated business income of that particular unit or church so that if a particular parish has unrelated business income net of only \$500, the extra \$500 of the exemption could not be used by another parish church or individual unit to offset its unrelated business income over its own \$1000 exemption. In other words, each individual church or unit or province of a religious order is entitled to exclude unrelated business income up to \$1000, but not more than its actual unrelated business income.

NEIL HAYES, DETROIT:

If your organization accepted a gift of real estate subject to a mortgage and time ran out and you paid off the mortgage, but the organization at the time of accepting the gift had signed an undertaking to the mortgage lender which provided that, if a subsequent sale of property produced a certain amount, your organization would pay x dollars, plus interest to them, would this be considered debt-financed? This was a gimmick that the mortgage bankers had worked out with our donor. They wanted us to sign a note, and we said at the time of accepting the gift that we wouldn't sign any notes, but we would honor whatever the donor had promised them.

NOLAN:

What is the nature of the undertaking to the mortgage bankers again?

HAYES:

Only that, if and when we sold any of this property, we realized more than \$100,000, we would pay them \$100,000 up to the point where we had received \$200,000. It was more of an effort on their part to grab a piece of the action. We don't give them anything until we have realized the We're selling pieces all the time.

NOLAN:

What's the mortgage on your property in this case?

HAYES:

Several million dollars. It was paid down over the course of the rental period, and when our time was running out, we paid off the balance so it wouldn't be debt financed.

NOLAN:

It sounds to me like you don't have a problem, but I'm nervous without looking at the

HAYES:

I'm nervous after listening to you.

BILL MURPHY, DIOCESE OF PROVIDENCE:

I'm going to give you a hypothetical. A corporation, a parent corporation, owns a school building with a heavy mortgage and rents the building

to a noncontrolled corporation which runs a Catholic school on the premises, substantially unrelated or substantially related, is that income from that rental taxable to the parish corporation in your opinion? In a school that has a regular course of Catholic instruction for grace and sacraments, everything that would otherwise be run in a parochial school.

NOLAN:

Is it a noncontrolled organization?

MURPHY:

It's a noncontrolled organization.

NOLAN:

And the rent is a fixed amount?

MURPHY:

Yes. Fair market value, arm's-length transaction.

NOLAN:

But, it's fixed, it's not your tuition payments or anything?

MURPHY:

No, it's a fixed amount.

NOLAN:

Is the organization to which it is leased a profit-making organization?

MURPHY:

Nonprofit.

NOLAN:

I don't think you have a problem.

MURPHY:

The second part of the problem that's disturbed me for quite a while is the possible constitutional problem here. The Service can come in and examine the function—let's see in this situation—to examine whether or not it's a substantial religious operation, substantially related to the activity of the parent church. Isn't there a problem of excessive involvement here?

NOLAN:

What is the basis for the exemption of the controlled organization?

MURPHY:

The lessee is an educational—claims an exemption as an educational institution.

NOLAN:

Not organized for profit?

MURPHY:

That's right.

NOLAN:

Then there's no occasion for the IRS to come in and look into the religious activities involved. Their examination should be limited to determining whether that organization is providing education, not-for-profit, under terms where no part of the income inures to the benefit of any private shareholder.

MURPHY:

Let me change the hypothetical a bit—let's assume it's a seminary, which was originally a Diocesan seminary, and which is now leased to a religious congregation for its own religious seminary, and the congregation is exempt as under the religious language of section 501(c)(3), as a church. Isn't there a substantial problem here when the Service can come in and analyze the activities of the organization claiming the religious exemption to determine whether or not it is a religious activity?

NOLAN:

I don't think so. It seems to me that if an organization claims exemption from income tax on the ground that it is engaged in religious or other related charitable activities, the Internal Revenue Service has a perfect constitutional right to make an inquiry whether, in fact, they are engaged in religious and charitable activities.

MURPHY:

But how does the Service answer that question? How does the Service determine whether or not an activity is a religious activity?

NOLAN:

They must determine from the nature of the activity of the organization whether it is religious or not. They must face this problem all the time with respect to groups that claim exemption as religious bodies or as churches where it is marginal whether they are, in fact, a church or a religious body. The Service must make a determination whether what they are doing is in fact the conduct of religion. The Code requires such a determination as the basis for tax exemption. It is not an easy determination to make. It is one of the more difficult problems that face the Service from time to time, but they are obligated to make the determinations.